Office of the Secretary
Service Date
September 4, 1996

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF IDAHO POWER COMPANY FOR AN ORDER APPROVING THE METHODOLOGY FOR AVOIDED COST RATE NEGOTIATIONS WITH QUALIFYING FACILITIES LARGER THAN 1 MEGAWATT.	**CASE NO. IPC-E-95-9** **ORDER NO. 26576**

BACKGROUND

On July 17, 1995, the Idaho Power Company (Idaho Power; Company) filed an Application for an Order approving a methodology for conducting avoided cost rate negotiations with qualifying facilities (QFs) 1 megawatt (MW) or larger.

Idaho Power's Application was anticipated by the Commission in Order No. 25884 (issued in Case No. IPC-E-93-28) in which the Commission stated:

> We expect the Company to include with its 1995 IRP filing, a more detailed proposal of how the least cost planning based avoided cost methodology will operate. We will treat that filing as a generic discussion of the issue and expect all interested parties, including the other utilities, to intervene and participate so that all issues may be resolved and the methodology can be refined.

Order No. 25884 at p. 7

Pursuant to the Commission's directive, The Washington Water Power Company (Water Power) and PacifiCorp were designated as parties to this proceeding. In addition, a number of independent power developers intervened as parties.

Subsequent to the filing of Idaho Power's Application, a number of interested parties conducted a series of settlement negotiations in an attempt to craft an avoided cost methodology for larger projects that was acceptable to all concerned. With the exception of several issues, the parties were ultimately able to agree upon a methodology which was formulated primarily by the Commission Staff but with the assistance of all those who participated in the settlement negotiations. The proposed methodology, which is based essentially on each utility's integrated resource plan, was

included as Exhibit No. 101 to the testimony of Commission Staff witness Rick Sterling presented at the technical hearing conducted by the Commission in this case on July 2, 1996.

Under the proposed methodology, the avoided cost of a QF project is determined as the cost which the utility would avoid if it purchased power from the QF, rather than acquiring the same power from the resources selected in its base case resource plan. The value of power from the QF is dictated by the type, amount, timing and cost of the resources in the IRP which would be displaced or deferred.

With the exception of three issues discussed below, none of the parties who participated in this case objected to Staff's proposed methodology. In fact, Idaho Power, Water Power, PacifiCorp and Rosebud Enterprises, Inc. executed the Settlement Stipulation agreeing to Staff's proposed methodology with the three exceptions. The other parties to the case chose not to sign the Stipulation but did not oppose the methodology.

The three unresolved issues relate to the standard contract term over which QFs are entitled to receive the avoided cost rate, whether levelized rates should be offered to QFs and whether PacifiCorp should be allowed to adjust the input data used in the Company's IRP model to reduce PacifiCorp's reserve margin from 12% to 10%.

DISCUSSION AND FINDINGS

We commend the parties for the considerable time and energy expended in addressing what has long been one of the most contentious matters to come before this Commission; the setting of avoided cost rates. When we issued Order No. 25884, we recognized that the use of a surrogate avoided resource (SAR) for setting avoided cost rates for larger QF projects was no longer adequate given the rapidly changing nature of the industry and the manner in which utilities actually acquire resources. The Commission Staff and the other parties to this case have answered the call in devising a methodology that more closely reflects the manner in which utilities acquire and price generation resources than did the use of a single, hypothetical power plant. As we discuss below, the industry is changing with such speed that the use of any particular formula for setting avoided cost rates will have inherent shortcomings. Nonetheless, we find that the methodology proposed by the parties in this case is the most reasonable means of establishing avoided cost rates for larger QFs at this time. We now turn to the issues left unresolved by the Settlement Stipulation.

Contract Length

The Commission's current policy, as established in Order No. 21630, Case No. U-1500-170, is that QFs are entitled to contracts up to 20 years. Although the actual useful life of the project may exceed that time period, the QFs are free to renegotiate a contract with the utility or with any other buyer at the expiration of the 20-year term. In this proceeding, the Commission Staff advocates maintaining the standard 20-year contract term. Staff contends that it is reasonable to require 20-year contracts for QFs since utilities' long-term acquisition planning is still primarily based on the acquisition of long-lived resources under long-term commitments including the relicensing of hydro projects and DSM programs. Staff reasons that as long as the rates that utilities pay for QF power are based on the utility's avoidance of planned resources, the utilities should be required to offer 20-year contracts if the planned resources have lives of 20 years or more. Staff believes that although utilities are currently relying on short-term market purchases to satisfy their short-term needs, the fact that their respective IRPs call for the acquisition of long-term resources cannot be overlooked and justifies requiring 20-year contract terms for QF projects. Staff argues that short-term market purchases can be used in the proposed methodology, but only to the extent those market purchases have been included in the utility's IRP.

Idaho Power proposes that the standard contract terms for QF projects larger than 1 megawatt should no longer be a fixed contract length. Rather, the expectation should be that QFs will be offered contracts with terms "similar in length to those offered by the utility for other resources being acquired contemporaneously." Idaho Power's witness John Willmorth argues that, due to the current surplus of resources in the region and the uncertainty about future resource needs, resources are being acquired by utilities for periods generally no longer than five years. Consequently, the maximum contract length which should be offered to large QFs at this time should not exceed five years, he argues. Idaho Power contends that it has no plans to build, own or operate new generating facilities to meet load growth. Instead, as the competitive wholesale power markets expand, Idaho Power plans to supplement its existing resources as necessary with market purchases of capacity and energy. These will be short-term purchases, the Company argues, and consequently, Idaho Power should not be required to offer QF contracts greater than five years during this period of transition.

Willmorth argues that although Idaho Power had originally proposed the IRP methodology, it will not remain a viable basis for calculating utility avoided costs given the dynamic nature of the industry. He suggests that competition is likely to radically change or eliminate the need for the IRP and to erode the relationship between the determination of avoided cost and the resource plans of individual utilities. Consequently, avoided costs will need to be calculated using a more direct market price methodology. He urges the Commission to convene a proceeding shortly after concluding this case to investigate the future role of the IRP and the feasibility of eliminating administratively determined avoided costs in favor of a direct determination of the QF rate from the published price of an equivalent market purchase.

PacifiCorp also believes that avoided cost rates must soon be established by a more market-based methodology but agrees that Staff's proposed methodology is appropriate for the interim. Like Idaho Power, PacifiCorp opposes the standard 20-year contract term for QFs arguing that it unduly protects them from the competitive market forces with which all other wholesale market participants have to contend and leads to overstated avoided cost prices. PacifiCorp proposes that any QF contracts offered in excess of five years should include a market adjustment clause to avoid the risk that utilities' customers will pay prices for QF power that is in excess of current market prices.

PacifiCorp proposes that the contract structure and pricing terms offered to QF developers should reflect those in the market, i.e., what is avoided by a QF contract. The Company argues that the optimal contract structure the Commission should adopt includes a five-year term with a developer option for full levelization during that term. If the terms are kept to five years or less, the Company does not believe that market adjustments would be necessary or appropriate. Pricing in the subsequent periods would be based on subsequent market conditions. If the Commission decides to continue with contract terms in excess of five years, PacifiCorp proposes that it be allowed to include provisions in its contracts which would allow the risk of longer term contracts to be shared. For instance, the Commission could adopt contracts which have five years of initial pricing followed by market adjustments at the beginning of the sixth, eleventh and sixteenth years. The market adjustment would true-up prices to a published market index such as the California-Oregon Border or Palo Verde electricity indexes or other indices which are a good

measure of current electricity prices. Prices between adjustment years could be based on the prior year's price adjusted by an inflation index.

The second option could involve a plus or minus 10% deadband being placed around a predetermined price. If the actual price of electricity in the market were outside the deadband, prices would automatically be reset to the published market price with a new deadband established.

Water Power also opposes maintaining the 20-year contract term. As an alternative to Staff's proposal, Water Power recommends that utilities be required to offer fixed prices for terms no longer than five years. Water Power witness Douglas Young suggests that QF developers should be able to request long-term contracts up to ten years, but after five years the price provisions of the contracts should be renegotiated or revised to reflect then current market conditions. Young asserts that the electric industry is in such a state of flux that 20-year price forecasts are not possible. Furthermore, he argues that five years is closer to the average length of electric purchase and sales transactions which Water Power has recently experienced in the power market.

Rosebud's witness Richard Slaughter advocates maintaining the standard 20-year contract term. He notes that short-term market prices could just as easily rise as fall and that this has always been the case in the industry. He suggests, in fact, that there are reasons to believe that the low gas prices experienced in recent years may soon start to rise as utilities become increasingly reliant upon this resource and supply becomes increasingly scarce. In any event, he contends, it is unlikely that gas prices will fall much lower. Slaughter notes that under the various utilities' proposals, utility shareholders and ratepayers would both benefit in the event that market prices decline. If they were to increase, however, ratepayers would bear the entire burden because contracts with QFs would be renegotiated at higher prices. Finally, Slaughter notes that no developer can obtain financing for a project with a guaranteed price of only five years. Consequently, he asserts, that without contracts of at least 20 years, there will be no competition in the energy market from qualified developers. Slaughter also questions the credibility of utilities who, on the one hand contend that they wish to treat QF resources the same as their own, yet are not proposing to forego rate base treatment of long-lived, Company-owned assets, e.g., hydro relicensing, DSM, etc.

We find:

PURPA was enacted to encourage the promotion and development of renewable energy technologies as alternatives to fossil fuels and the construction of new generating facilities by

electric utilities. *American Paper Institute, Inc. v. American Electric Power Service Corp.*, 461 U.S. 402, 103 S.Ct. 1921, 76 L.Ed.2d 22 (1983). Pursuant to congressional directive, FERC promulgated rules implementing sections 201 and 210 of PURPA. Section 210 requires electric utilities to purchase electricity produced by QFs. 16 U.S.C. § 824a-3(b), (d).

Under FERC rules, utilities are required to purchase QF power at a rate of payment equal to the utility's full avoided cost. 18 C.F.R. § 292.304(b)(2). "Avoided costs" are the incremental costs to the electric utility of power which, but for the purchase from the QF, such utility would generate itself or purchase from another source. 18 C.F.R. § 292.101(b)(6).

FERC promulgated the general scheme and rules but left the actual implementation of establishing avoided costs to the regulatory authorities of the individual states. The grant of authority to the states in implementing the regulation of sales and purchases between QFs and electric utilities, both substantively and procedurally, is broad. *See, Federal Energy Regulatory Commission v. Mississippi*, 456 U.S. 472, 102 S.Ct. 2126, 72 L.Ed.2d 532 (1982).

PURPA, and the implementing regulations, require only that avoided costs be established and made available to QFs with a capacity of 100 kilowatts or less. 18 C.F.R. § 292.304(c). The Act and regulations are silent as to the length of the contract over which the QF is entitled to receive the avoided cost rate. Consequently, this is a matter that lies within this Commission's discretion. The Commission's policy with respect to the standard contract length has evolved over the years. Prior to 1987, utilities were obligated to provide QFs with 35-year contracts. In Order No. 21630, issued in Case No. U-1500-170, the Commission shortened the standard contract length to 20 years reasoning that risk and uncertainty inherent in long-range forecasting increases dramatically with time and that a shorter contract term would reduce that risk. The Commission ruled that contracts longer than 20 years would be available to QFs only upon a persuasive showing of need.

Significant changes have swept through the electric industry since we last examined the issue of contract length. The FERC has mandated open access to the transmission system, thermal technologies have improved, gas prices are low, there is a considerable surplus of energy available in this region resulting in very low spot market prices for electricity and, finally, even the continued existence of PURPA is being called into question. We find that as the industry as a whole continues to transform to a more free market model, we cannot justify obligating utilities to 20-year contracts for PURPA power. As the utilities in this case note, such an obligation does not reflect the manner

in which they are currently acquiring power to meet new load; through short-term (five years or less) purchases. Consequently, it would be nothing more than an artificial shelter to the QF industry to provide those projects with contract terms not otherwise available in the free market. We can find no justification for insisting that Idaho's investor-owned utilities and their ratepayers assume such an obligation simply to foster one particular segment of an increasingly competitive industry. We find, therefore, that Idaho's investor-owned utilities shall not be required to offer contracts to QFs in excess of five years until further action is taken by this Commission. This ruling, however, does not prevent utilities from offering for approval QF contracts with terms that exceed five years should the utilities believe that such contracts are in the best interests of their ratepayers.

Levelized Rates

Under the Commission's current policy, levelized rates are available to any QF developer who desires them. Nonlevelized rates are high in later years of the contract while levelized rates are equal throughout the contract term. Levelized rates are often considered essential by developers of projects with high, up-front capital costs.

The arguments for and against offering levelized rates for QF projects are essentially the same as with respect to contract length. Staff simply argues that the levelization of rates is not an issue in this case. In the combined avoided cost cases, WWP-E-93-10, IPC-E-93-28, PPL-E-93-5/UPL-E-9-37 and UPL-E-93-3/PPL-E-93-3, which initiated the present proceeding, the Commission stated in Order Nos. 25882, 25883 and 25884:

> The levelization of avoided cost payments is another tool that this Commission has historically relied upon in encouraging and assisting smaller QFs by providing a cash stream that better enables them to satisfy their debt service in the early years of their contracts. Although, we have taken considerable strides toward market-based pricing, we find that levelization for projects above 1 MW should be continued. We believe that levelization more accurately reflects the way in which costs are recovered for utility-owned projects. The utilities are directed to provide levelized rates, for all QF projects who desire it, utilizing the same procedure incorporated in the SAR methodology.

Idaho Power does not support mandatory rate levelization but agrees that it is a legitimate item for contract negotiations on a case-by-case basis. Willmorth suggests that an appropriate standard is that QFs should be offered the same opportunity for rate levelization as is

contemporaneously being offered by the utility for similar alternative purchases. He argues that the issues of contract length and rate levelization are related. When actual avoided costs tend to increase year after year, rate levelization results in shifting avoided costs from the later years of the QF contract into the earlier years of the contract thereby producing QF rates which systematically exceed avoided costs through a portion of the contract life. The shorter the contract length, the less the cost shifting and early overpayment in rates due to rate levelization.

PacifiCorp argues that rate levelization should be offered but under the condition that contract length not exceed five years.

Water Power disagrees with Staff's contention that rate levelization is not an issue in this case. According to witness Douglas Young, levelization is incident to the pricing provisions of purchase contracts. Water Power simply argues that so long as contract length does not exceed five years, the risks attendant to rate levelization are acceptable to the Company.

Finally, Rosebud witness Slaughter argues that levelization is as important as a 20-year contract term for facilities with high capital cost and low fuel expense. He argues that levelization also presents the ratepayer with a rate risk most similar to that experienced with utility-owned plants. He suggests that a levelized long-term contract is the resource whose attributes are most like utility-owned plant. He concedes that there are risks in such arrangements but argues that there are also potential rewards especially as the energy market approaches the lower bound of its long-term cost history.

We find:

The three utilities in this proceeding agreed that if the standard contract length were reduced to five years, that levelized rate should be offered to any QF desiring them. We find, therefore, that all QFs larger than 1 MW shall be entitled to levelized rates should they so desire them.

Reserve Margin

PacifiCorp, through the prefiled testimony of witness Laren Hale, proposed a number of changes to the input data used in the Company's IRP model to calculate avoided cost rates that are different than data contained in RAMPP-4; the most recent IRP.

Staff believes that all of the changes should be allowed with one exception; reducing the reserve margin from 12% to 10%. According to Staff witness Sterling, all of the other changes are

either identified in the section of the Company's IRP titled "Revisions to Inputs," are necessary in order to use the model for avoided cost calculations or allowed by the Settlement Stipulation to be updated on a semi-annual basis. Sterling argues, however, that a reduction in PacifiCorp's reserve margin was not identified in the IRP or its revisions and is not specifically permitted by the Stipulation.

In rebuttal, PacifiCorp witness Weaver concedes that the Settlement Stipulation does not allow for a revision to the Company's reserve margin which is why the Company is now seeking Commission approval. Weaver notes that the issue of reserve margin is currently under discussion in the Company's RAMPP-5 IRP. Because of the regional surplus of capacity, PacifiCorp believes that a reduction in reserve margin is warranted.

We find:

Pursuant to the settlement discussions, the three investor-owned utilities that are party to this proceeding were allowed 45 days in which to make amended IRP filings for the purpose of making avoided cost calculations. This invitation to make amended filings was set forth in the Notice of Scheduling in the three utilities' pending IRP cases. PacifiCorp never made an amended filing in response to this invitation. Instead, it included proposed changes to its reserve margin for the first time in the prefiled testimony of one of its witnesses.

We find that it would be inappropriate to allow PacifiCorp a last minute amendment to its IRP in a case not initiated for that purpose, and in which no notice was given that such an amendment may occur. This Commission has previously established a methodology for the filing and review of utilities' IRPs and we are not compelled to bypass that methodology by allowing a last minute change in an unrelated case. We further note that PacifiCorp will file its next IRP (RAMPP-5) in early 1997. That is the proper proceeding in which to review the adequacy of the Company's reserve margin.

ORDER

IT IS HEREBY ORDERED that the Settlement Stipulation set forth in Staff Exhibit No. 101 establishing a methodology for setting avoided cost rates for QFs 1 MW and larger is hereby approved subject to the terms and conditions set forth herein.

THIS IS A FINAL ORDER. Any person interested in this Order (or in issues finally decided by this Order) or in interlocutory Orders previously issued in this Case No. IPC-E-95-9 may petition for reconsideration within twenty-one (21) days of the service date of this Order with regard to any matter decided in this Order or in interlocutory Orders previously issued in this Case No. IPC-E-95-9 . Within seven (7) days after any person has petitioned for reconsideration, any other person may cross-petition for reconsideration. See *Idaho Code* § 61-626.

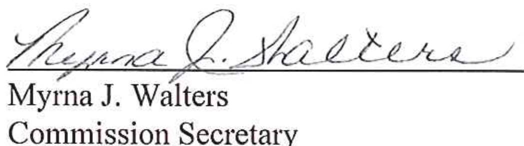
DONE by Order of the Idaho Public Utilities Commission at Boise, Idaho this 4th day of ~~August~~ September 1996.

RALPH NELSON, PRESIDENT

MARSHA H. SMITH, COMMISSIONER

DENNIS S. HANSEN, COMMISSIONER

ATTEST:



Myrna J. Walters
Commission Secretary

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